FEDERAL RESERVE BANK OF CHICAGO

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Federal Reserve Bank of Chicago 2004 Annual Report
The economy entered the year with significant momentum, thanks in part to a highly accommodative monetary policy put in place to help foster a recovery from the 2001 recession. With this momentum, the economy’s vitality spread into areas that had struggled in the previous two years — specifically the manufacturing sector and labor markets.

With that in mind, the Federal Open Market Committee (FOMC) during 2004 sharpened its focus on inflation. Prices for many commodities increased during most of the year, but none drew as widespread attention as oil prices. The price for a barrel of West Texas Intermediate crude (the bellwether of energy prices) topped $55 in October — well above the $30 average that persisted between 2000 and 2002. As 2004 progressed, core inflation measures moved up from the extremely low rates in late 2003.

Even though the uptick in inflation was widely viewed as temporary and inflation expectations remained contained, it became clear that the highly accommodative monetary policy that had been needed earlier in the recovery was no longer necessary. As a result, the FOMC began to remove its policy accommodation. Beginning in June 2004, we increased our target for the federal funds rate from 1 percent and eventually pushed the rate to 2.75 percent in March 2005.

Even with tighter monetary policy, the economy continued to expand in 2004. Manufacturing production grew at the fastest rate in five years, and payroll employment increased in all 12 months of the year for the first time since 1999. By early 2005, both production and employment surpassed the level of their previous peaks, a sure sign that the economy had shifted from recovery mode to expansion.

Community Banks Play Important Role in Regional Economy

In this year’s annual report, we are taking a close look at community banking. Because of the services they provide small businesses, farms and households, community banks play an important role in the economy of the Seventh
Federal Reserve District (Iowa and most of Illinois, Indiana, Wisconsin and Michigan). We’re home to more community banks than any of the other 11 Fed districts.

An essay starting on page 7 offers a comprehensive look at the current state of community banks in the U.S. It explains why community banks are unique, documents the reasons for their declining numbers in recent years, and offers a perspective on what they must do to be competitive moving forward. The conclusion is that in a constantly changing environment, with fierce competition from a wide variety of other financial services providers, those community banks that are well-run and efficiently managed will not only survive, but thrive.

Electronic Payment Growth Forces Check-Processing Consolidations

Another issue we’re watching closely is the continued growth of electronic payments. Consumers continue to move away from paper checks (See chart at right). A recent Federal Reserve payment study confirms that U.S. electronic payment transactions in 2003 exceeded check payments for the first time. Between 2000 and 2003, check payments declined an average of 4.3 percent, while electronic payment transactions jumped an average of 13.2 percent.

While the shift is beneficial to the payment system, it has had a profound impact on our check-processing operations. We are consolidating Federal Reserve check-processing facilities across the country. By early next year, the number of check-processing sites will have decreased from 45 to 23. Of all the restructuring throughout the Federal Reserve System, the most took place in the Seventh District. For example:

- The Omaha check-processing office closed in April of 2004, with the Chicago Fed’s Des Moines office picking up the volume.
- In July of 2004, the Chicago Fed’s Milwaukee office closed. Those checks transferred to the Chicago Midway office, where we expanded our capacity to handle additional volume.
- The Chicago Fed in October of 2004 closed its Peoria office in central Illinois, with that volume shifting to the Chicago Midway office.
- The Chicago Fed’s Indianapolis office also closed in October of 2004, with that volume shifting to the Cincinnati office.
- In addition, checks being processed at our Detroit branch are slated to transfer in mid-April of 2005 to the Cleveland office.

Despite this much restructuring, our staff continued to provide high-quality check services to our customers. I’m pleased to say the consolidations have gone very well. Our check-processing operations are now more efficient, with costs more in line with revenue. Our Chicago Midway office is processing roughly 3 million checks a day. Overall, more than 2 billion checks were processed in the Seventh District in 2004, with the Check Department achieving local net revenue financial targets.

We will monitor trends in the payments industry, and we’re confident we are structured to provide efficient, high-quality service for years to come.

Other 2004 Accomplishments

Other notable accomplishments in 2004 include the work of our Customer Relations and Support Office (CRSO), which serves the entire Federal Reserve System. Despite a tight deadline and technology challenges, the CRSO rolled out Fedline Advantage, which allows customers to conduct high-value, high-risk transactions securely via the Web.

In Supervision & Regulation (S&RR), Senior Vice President Cathy Lemieux was promoted in November to lead the department. Throughout the year, S&RR continued to improve its risk assessment process by focusing on risk identification, analysis and resolution. We carried out roughly 1,100 examinations, inspections and off-site reviews and also offered training to almost 600 directors of community banks.

Economic Research also had an outstanding year in its effort to produce innovative research that leads to the development of informed public policy. The Research Department had more articles (21) selected to be included in scholarly publications than in any of the 10 years I have been at the Bank.

Work was also completed at our downtown Chicago headquarters on a comprehensive set of building improvements to enhance security and ensure employee safety. In addition, progress continued on construction of our new Detroit Branch building (See photo), slated to open in January 2006 with improved security and an expanded, state-of-the-art cash vault.

Looking at operations across the board, support and overhead costs in the Seventh District were 10% below budget in 2004 without impacting service levels or incurring any undue risk. We also made significant progress in enhancing internal controls.

These are just a few of our 2004 highlights. I invite you to look over a more comprehensive listing starting on the next page. These would not have been possible without the dedicated commitment of our staff members who remained productive and focused through a challenging year.

Thanks to our Directors

Commitment is also a good word to use when discussing the two teams of directors who provided us with perspective, guidance and counsel. I’d specifically like to thank the directors who retired at the end of 2004: James H. Keyes and Alan R. Tubbs from the Chicago board and Robert E. Churchill from the Detroit board. Their contributions are very much appreciated.

In 2005, we welcomed three new members to our boards. Joining our Chicago board are Mindy C. Meads, CEO of Lands’ End, Inc. and executive vice president at Sears, Roebuck and Co., and Jeff Plagge, president and CEO of The First National Bank of Waverly in Waverly, Iowa; president of the First of Waverly Corporation; and CEO of the First National Bank of Cedar Falls and First Insurance Services. Joining the Detroit board is Michael M. Magee Jr., president and CEO of Independent Bank Corporation in Ionia, Michigan.

I am personally very thankful for the contributions of our directors. With their hard work and that of our staff, we are well positioned to continue our efforts in 2005 to foster a strong economy and a stable payment system.

Michael H. Moskow
President and Chief Executive Officer
April 1, 2005
CHICAGO FED HIGHLIGHTS OF 2004

First Quarter

- Supervision and Regulation continues efforts to improve its risk assessment process focusing on risk identification, analysis and resolution.
- Chicago Fed President Michael Moskow appears on CNBC-TV’s Squawk Box, one of his more than 25 public appearances in 2004 to discuss banking and economic issues.
- Significant progress is made during the year toward implementing a comprehensive risk management framework and strengthening internal controls.
- The Bank sponsors a Money Smart Week in both Chicago and Detroit to inform consumers about managing their personal finances.
- A public hearing takes place at the Chicago Fed on the proposed merger of Bank One and J.P. Morgan Chase & Co.

Second Quarter

- The Bank hosts its 40th annual Conference on Bank Structure and Competition titled, How Do Banks Compete? Strategy, Regulation, and Technology; it is one of 29 research and public policy conferences conducted throughout the year: (1)
- Supervision and Regulation starts community bank director training sessions throughout the Seventh District. During the year, more than 600 directors are educated about regulatory compliance and other supervisory issues.
- The Bank sponsors a Money Smart Week in both Chicago and Detroit to inform consumers about managing their personal finances.
- A public hearing takes place at the Chicago Fed on the proposed merger of Bank One and J.P. Morgan Chase & Co.

Third Quarter

- Work continues at Chicago headquarters on a comprehensive set of building improvements carried out throughout the year to enhance security and ensure employee safety: (2)
- As part of a national consolidation of check-processing facilities, the Omaha check-processing office closes, with volume shifting to the Chicago Fed’s Des Moines office.
- People Practices’ Gene Mysiarewicz, the Bank’s longest-tenured staff member, retires after 49 years of service.
- Staff celebrates the 40th anniversary of the Bank’s incorporation. Later in the year, the Chicago Fed celebrates the 90th anniversary of when it opened for business: (4)
- Economist Bhashkar Mazumder examines sibling similarities, differences and economic inequality in one of 30 working papers published by Economic Research during the year.
- Redesigned $50 bills, containing enhanced security features, are distributed to financial institutions: (5)
- Students from St. Charles North High School in St. Charles, Illinois tour the Bank’s Visitors Center, part of a record 21,000 who visited the center in 2004
- Work progresses on management of the Federal Reserve’s national financial services marketing efforts being centralized in the Bank’s Customer Relations and Support Office improving effectiveness and reducing costs.

Fourth Quarter

- More than 2 billion checks are processed in the Seventh District throughout the year, with the Check department achieving local net revenue financial targets.
- Support and overhead costs in the Seventh District drop 10 percent in 2004 without impacting service levels or incurring any undue risk.
- Throughout the year, Economic Research has 21 papers accepted for publication in scholarly journals.

(1) Supervision and Regulation
(2) Economic Research
(3) Supervision and Regulation
(4) Economic Research
(5) Economic Research
(6) Economic Research
As the population of community banks continues to decline, some worry that this most traditional of U.S. financial institutions might no longer be viable. But a careful look at the data doesn’t square with a path to extinction. Instead, the evidence suggests a process of natural selection in which well-run community banks will thrive.

Large banks are everywhere. You’ve paid them more attention lately, especially since they set up shop in your town by buying local banks and changing the signs. They advertise during all the football games you watch on television, and some of the arenas are even named after them. And they always seem to be opening new branches – near your office, in your supermarket, and next to your shopping mall. In fact, following the lead of several tony Chicago suburbs, your town council is considering an ordinance that would ban any new bank branches from opening on Main Street.

But there are still small banks in your town. One community bank has been there as long as you can remember. You don’t need a TV commercial to remind you, because you’ve driven or walked past it nearly every day of your life. It’s where your parents took you to open your first savings account, and where you received the mortgage to buy your first home. It finances your neighbor’s business and your brother’s farm, and it manages your parents’ retirement investments. No one would dream of banning this bank from Main Street.
What is a Community Bank?

The word “community” infers a smallness and a connectedness — but a separateness as well. From Webster’s Dictionary, a community is “a group of people with a common characteristic or interest living together within a larger society.” Community banks serve the financial needs of community residents — local businesses and households — so that they can make their own unique contributions to the larger economy.

A community bank is a nexus of financial, human, and social capital not easily described in purely quantitative terms. Chiefly important is its local focus. Its owners and its managers have a personal economic stake in the local economy. Its competitive advantage derives directly from its first-hand knowledge of the people, businesses, and institutions driving the local economy.

To some, the community bank is a manifestation of the Jeffersonian ideal of local economic power, self-employment, and reinvesting local savings in local businesses. In less grand terms, community banks meet the financial needs of their customers — whether in the form of a personal loan, a small deposit account, or checking services, but it can grind to a halt if it tries to account for the differences among individual customers.

Two Very Different Business Models for Large Banks and Medium-Sized Community Banks

<table>
<thead>
<tr>
<th>Measure</th>
<th>Small deposits per 0.1¢ of assets</th>
<th>Medium deposits per 0.1¢ of assets</th>
<th>Large deposits per 0.1¢ of assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising spending per $1 of assets</td>
<td>$0.04</td>
<td>$0.08</td>
<td>$0.20</td>
</tr>
<tr>
<td>Core deposits per 0.1¢ of assets</td>
<td>$0.10</td>
<td>$0.10</td>
<td>$0.10</td>
</tr>
<tr>
<td>Overnight funding per $1 of assets</td>
<td>$0.06</td>
<td>$0.08</td>
<td>$0.12</td>
</tr>
<tr>
<td>Fee income per $1 of assets</td>
<td>$0.06</td>
<td>$0.08</td>
<td>$0.12</td>
</tr>
<tr>
<td>Small business loans per $1 of assets</td>
<td>$0.10</td>
<td>$0.10</td>
<td>$0.10</td>
</tr>
<tr>
<td>Consumer loans per $1 of assets</td>
<td>$0.06</td>
<td>$0.08</td>
<td>$0.12</td>
</tr>
</tbody>
</table>

A Declining Community Bank Population

A general rule of thumb defines community banks as those with less than $1 billion in assets. There are approximately 7,000 such community commercial banks in the U.S. today, and they account for about 95% of the total number of U.S. commercial banks. This is a substantial number of banks: approximately one community bank for every 40,000 U.S. citizens, a much higher multiple than in most other western economies. But compared with our recent past, this is a very small number of community banks. The population of U.S. community banks has been cut in half since 1985, when they numbered nearly 14,000. This huge decline would be a small issue if community banks held their market share constant. But they have not. The share of U.S. banking assets held by community banks has declined in recent years.

In the wake of the Great Depression and the ensuing economic downturn, the U.S. experienced a national banking crisis that led to the implementation of the Glass-Steagall Act of 1933. The act prohibited commercial banks from engaging in investment banking activities, which had been a significant source of revenue for many large banks.

A Less Hospitable Landscape

The U.S. is a vast nation, with clusters of economic activity separated by wide geographic spaces. And America has a long history of local political and economic control — as evidenced by the powers held by the 50 state governments to grant local banking charters. In such a world — especially before advances in information and communications technologies allowed financial information to travel instantly across these wide spaces — it is not surprising that the economic infrastructures in the U.S. would in many ways be local ones, and would feature large numbers of community banks. Federal and state regulations traditionally protected these local financial institutions from competition. The McFadden Act of 1927 prohibited rival banking companies from crossing state borders to compete with one another, and in many states banks were prohibited from crossing even county borders. The Federal Reserve’s Regulation Q limited the rates that banks could pay to attract depositors, further reducing competition. And the Glass-Steagall Act of 1933 prohibited commercial banks from engaging in the activities of investment banks, securities firms, and insurance companies (and vice versa), further insulating commercial banks from competition.
This was a fabulous world for community bankers. Protected from competition, they could earn strong profits. Or alternatively, they could choose to earn satisfactory profits and simply lead a quiet life.

This environment kept the price of financial services artificially high, reduced banks’ incentives to innovate, and bred a population of community bankers largely inexperienced with competitive rivalry. When state and federal regulatory protections were dismantled in the 1980s and 1990s, community banks began to disappear. Aggressive banking companies starved for growth began to move across state borders, and the fastest channel for growth was to acquire existing community banks.

Inefficient and poorly run community banks made especially attractive acquisition candidates. If a community bank could not flourish under the new competitive conditions, it could be purchased for a relatively low price. As an economist would say, these banks had a low opportunity cost for their capital. Consistent with this, about 95% of the nearly 1,300 commercial banks that failed during the 1980s and 1990s have been community banks, further testimony to the inefficiencies bred by years of regulatory protection.

Viewed in this historical context, the recent decline in the number and market share of community banks isn’t necessarily a sign that community banks can’t be competitive in the future – instead, these changes may simply mark a transformation to a new industry equilibrium. Artificial regulatory barriers had supported an over-populated and inefficient community banking sector, and removing those barriers is allowing the industry to move toward a more ‘normal’ and efficient structure.

David and Goliath?
Is this process of industry consolidation drawing to a close, or is there still a substantial number of community banks left to disappear? How do existing community banks – those that have so far survived the consolidation process – stack up against their larger bank rivals?

In terms of size, community banks are trifling compared with regional, super-regional, and nationwide banking companies. The largest U.S. banking company, the Bank of America, has well over $1 trillion in assets. Those twelve zeros make it one thousand times larger than the biggest community banks of about $1 billion! What if we use a less extreme benchmark, say, the typical regional banking company with about $50 billion in assets? The biggest community banks are still only about one-fifth this size.

There is wide agreement among banking economists that community banks’ small size puts them at a cost disadvantage relative to their large bank rivals. Scale economies – that is, the reduction in unit costs that a bank captures by growing larger – are difficult to measure exactly for commercial banks. However, there is general agreement that scale economies have a strong cost-reducing effect for small banks and that scale economies continue to generate cost reductions for banks with well in excess of $1 billion of assets.

Size clearly makes a difference. Large banks can operate with less capital because they are well-diversified, and their large size and high profile gives them access to low-cost sources of equity and debt financing. Large banks can offer a wider set of financial services than community banks – from a full menu of investment and insurance products for households to the risk management tools and investment banking services demanded by large corporate clients. Large banks can access mass marketing channels to reach households in multiple geographic markets, use in-house research and development to develop proprietary financial products, and reap “convenience dividends” from their widespread systems of branches and ATMs.

But size is not everything. For many community banks, research has shown again and again that the largest source of cost disadvantages is not small scale, but old-fashioned cost inefficiency – this is, most community banks simply use more inputs (labor, branches, deposits) than necessary relative to best-practices community banks. As in any industry, poorly managed, high-cost firms will earn low returns and are unlikely to survive in the long run.

Large banks can make surprisingly little difference when it comes to using high-tech banking tools. For example, the hardware and software needed to provide Internet banking, electronic bill-pay, check imaging, retail portfolio analysis, and loan scoring are increasingly available to small banks at competitive prices. Moreover, the relationship mentality and non-bureaucratic nature of community banks can in many instances allow them to deploy these tools more quickly and more effectively than large banks.

This brings us to a crucial strategic distinction: By necessity, the decision-makers that run large organizations must operate at a distance from their smaller customers. This distance tends to be reflected in the type of products and quality of service that large banks offer their retail and small business customers – and community banks can be well positioned to exploit this.

Large Banks: High Volume, Low Cost
To service tens of thousands of separate retail accounts, large banks rely on automated interfaces rather than in-person contact. On the deposit side, large banks encourage their customers to use the Internet, ATMs, remote call centers, and other electronic channels rather than visiting human tellers at bank branches. On the lending side, large banks use automated credit scoring models to screen applications for credit cards, auto loans, home mortgages, and increasingly for very small business credit lines.

Because these automated processes exhibit substantial scale economies, they provide powerful cost advantages for large banking companies. But the widespread use of these automated processes at large banks has had an additional effect: It has turned traditional banking products into financial commodities.

The commoditization of retail banking has important strategic consequences for large and small banks: For example, mortgage lenders can use credit scoring models to produce portfolios of loans that are relatively similar in terms, conditions, and credit quality across borrowers. This homogeneity allows banks to re-package large volumes of these loans as asset-backed securities and sell these securities to investors. The financial proceeds can be plowed back into more lending, allowing already large banks to further increase their scale of operations without having to raise more capital.

High-volume securitized lending has reduced the cost of producing loans, expanded households’ access to credit, and supported macroeconomic growth by facilitating an historic number of home mortgage re-financings in recent years. But it has been a mixed blessing for large banking companies: As mortgages, auto loans, and credit cards were turned into financial commodities, lenders lost their pricing power in these lending markets – in fact, a good portion of the cost savings from automated lending processes is offset by lower lending rates in fiercely competitive commoditized markets.

Despite the pressure on profit margins, this approach has proven to be a profitable one for large retail banking companies. The keys to a successful high-volume, low-cost retail banking strategy seem to be continued expansion to achieve further scale and network economies, strong managerial oversight that holds the line on operating expenses, and establishment of a brand image that helps support prices. Large banks that cannot do these things successfully tend to become acquisition targets for other large banks seeking to grow.

Community Banks: Low Volume, High Quality
In contrast to their large bank rivals, community banks are low-volume, high-quality competitors. They eschew mass production and mass marketing, and instead target individual retail and small business customers who need...
customized financial products and desire in-person attention – and are willing to pay a premium for these services.

Relationship banking bonds the community bank to its customers. The most celebrated relationship-based product is the small business loan. Locally focused community banks have a clear advantage at assessing the creditworthiness, and monitoring the ongoing condition, of small and medium-sized businesses. These loans are customized to reflect the idiosyncrasies of these borrowers, and cannot be ‘put in a box’ for credit-scoring and securitization.

The low-volume, high-quality strategy is practiced on the deposit side as well. At a well-run community bank, business and household depositors can bank at an ATM, over the telephone, or on the Internet. But unlike large banking companies that offer their customers cash incentives to use these automated banking channels, community banks encourage their deposit customers to visit the bank for personal service.

Community bankers have an almost congenital tendency to make investments in the local community, by funding non-profit institutions and serving on a variety of boards and committees. Although these social investments are in many cases altruistic and generate only non-monetary returns, these activities also tend to reinforce the bonds between community banks and their customers. There is a financial symbiosis between the bank and its community – a sense that one cannot thrive without the success of the other. This contrasts with large banking companies that have an incentive to spend their charitable dollars in big cities where the public relations benefits are larger, and whose managers often rotate through local branches on their way to branches in bigger cities.

Customers are clearly willing to pay a premium for relationship banking. Community banks receive higher interest rates from relationship borrowers, and pay lower interest rates to their core depositors. For example, in 2003 interest rate margins at community banks averaged about 3.8%, substantially larger than the 3.2% margin earned by the typical large banking company. And strong relationships can lead naturally to the sale of fee-based products – like cash management services to business customers or retirement planning to household customers – without expensive marketing campaigns. If community banks are run well, high interest margins and cross-selling opportunities can offset the cost disadvantages of small size.

There are other indicators that relationship-based banking services are in strong demand in local markets. When a large banking company expands by purchasing a local community bank, it is not unusual for 10 percent (or more) of the purchased bank’s depositors to move their accounts to a competing community bank. And there are hundreds of community bank start-ups in the U.S. each year. More often than not, these brand new banks choose cities and towns where large out-of-state banking companies have recently acquired local banks.

Large banking companies have recently altered their expansion strategies, entering new markets by opening new branches rather than purchasing existing local banks. This has been especially true in Chicago, where Bank of America, Washington Mutual, Fifth Third and other large banking companies have opened hundreds of new branches in the past several years. This is a telling change. Expansion via branching has become relatively cheaper in part because the price of acquiring the remaining stock of community banks has increased – a signal that well-run community banking franchises located in attractive local markets have a strong economic future.

Meeting the Challenges

While local focus and strong customer relationships give community banks a powerful competitive advantage, it would be premature to conclude that the two-decades-long decline in the community banking sector has ended. Community banks are competing against rivals with increasingly strong competitive advantages of their own: credit unions with tax-advantaged status; large banking companies have opened hundreds of new branches in the past several years. This is a telling change. Expansion via branching has become relatively cheaper in part because the price of acquiring the remaining stock of community banks has increased – a signal that well-run community banking franchises located in attractive local markets have a strong economic future.
companies with size-based cost and marketing advantages, and specialized non-bank financial institutions – mortgage brokers, stock brokers, financial advisors, insurance agents, finance companies – that can siphon-off community bank customers product-by-product.

Competitive challenges abound. With large credit card banks and consumer finance companies dominating consumer credit markets, community banks have increased their concentrations of real estate loans, a sector in which managing credit risk and interest rate risk has historically been difficult for small banks. As consumer payments continue to evolve away from traditional paper-based checks, community banks must embrace online bill-pay, check imaging, and other new payments technologies, or risk losing some of their highest-valued customers. In direct competition with the securities industry for core household deposits, community banks must further enhance service quality and convenience, or else seek funding from other (perhaps more expensive) sources such as deposit brokers and Federal Home Loan Bank advances. As large banks continue to diversify into securities and insurance activities, community banks will have to forge partnerships with these large and small banks alike. The view of community banks as a Goldilocks’ problem may be too large, can lose its local focus and hence its special values, and community banks with at least $500 million in assets, returns-per-unit-of-risk were comparable to those generated by very large commercial banks. Management quality appears to make just as big a difference. Dividing the population of community banks into small, medium, and large size classes, and then separating the banks in each of these size classes into high ROE (above median, or “best-practices”) and low ROE (below median, or “worst-practices”) groups, the studies reveal some striking regularities. Although the smallest community banks face some of the toughest challenges, the data suggest that well-managed community banks of all sizes can generate financial returns quite comparable to those generated by the average large commercial bank. While some of their business came from mortgage refinancing, it misses out on potential scale economies, and its cost structure may be too high to remain profitable in a competitive marketplace. To remain financially viable over the long haul, a community bank has to be “just right” in terms of size.

Research performed at the Federal Reserve Bank of Chicago finds that a substantial portion of community banks have performed poorly in recent years. During the late 1990s and early 2000s, the average community bank generated a lower return-on-equity (ROE) than the average large banking company, and these earnings tended to be unstable as well – high in some years, low in others. Such a pattern of low returns, yet high-return volatility, does not properly compensate bank owners for risk. Were it to persist in the long-run, bank owners would eventually re-allocate their capital to more profitable investments – in other words, their banks would become acquisition targets and would disappear from the industry. But these studies also find that two broad classes of community banks generate stronger financial returns: larger community banks and well-managed community banks. As community banks increase in size, they are able to exploit economies of scale that drive down per-unit costs and drive up profitability. Increased size also reduces income volatility. For community banks with at least $500 million in assets, returns-per-unit-of-risk were comparable to those generated by very large commercial banks.

A Promising Future for Well-Run Community Banks

From a purely objective economic viewpoint, whether local markets are served by nationwide banks, regional banks or community banks should make no difference. The structure of the local banking industry will be decided by local consumers and business people, who will reward the banking companies that provide them with the best quality financial services at the lowest prices.

Although predicting the future can be a fool’s errand, the following scenario seems likely. Competitive forces will continue to separate the most efficient and progressive banks from the field – large and small banks alike. The best-run community banks will continue to grow larger, while the poorly run will continue to exit the market, with many being acquired by other community banks. As many as one-third to one-half of existing community banks may yet disappear before the banking industry reaches a more stable equilibrium, the remaining community banks will mostly be larger, and many will operate in more than one town or neighborhood. But ultimately the exact number of community banks and their collective share of U.S. banking markets are not the most important points. There is a more basic question: Is the locally focused, person-to-person banking approach – that is, community banks at their best – valued in the financial marketplace? The evidence presented in this essay strongly suggests that it is. A substantial portion of community banks are profitable and growing, the market values of these community bank franchises are strong, and new community bank start-ups are typically being well-received in the wake of large bank mergers. Collectively, these observations indicate that many households and small businesses are willing to pay a premium for this approach to banking – an approach that large banking companies find difficult to fully replicate.

Undoubtedly, the future for community banks will continue to be fraught with challenges. But there is abundant evidence that well-run community banks can meet these challenges, and will continue to be a part of the local banking landscape. It appears that there will still be a community bank on Main Street.

Robert Delbiingt is a senior economist and economic advisor in the Research Department at the Federal Reserve Bank of Chicago. Delbiingt’s current research focuses on the changing structure of domestic and international banking markets and the performance of the financial institutions operating in these markets. His analysis and commentary on these and other issues have appeared in numerous academic journals and industry publications.

The information in all charts is from the author’s calculations based on Federal Reserve Bank of Chicago data. The views expressed in this essay are the authors’ and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.
Two directors joined the Chicago Board in 2005:

- Mindy C. Meads, President and Chief Executive Officer, Lands’ End, Inc., Dodgeville, Wisconsin, who replaced James H. Keyes.

One director joined the Detroit Branch Board in 2005:

- Michael M. Magee, Jr., President and Chief Executive Officer, Independent Bank Corporation, Ionia, Michigan, who replaced Robert E. Churchill. 
As of December 31, 2004

Senior Vice President of the Financial Services Group Charles W. Furbee (left) retired on March 31, 2004 after 26 years of service. Senior Vice President of Supervision and Regulation James W. Nelson (center) left the Bank in October 2004 to take a position as Chief Risk Officer at Huntington Bancshares in Columbus, Ohio. Senior Vice President and Special Advisor to the President Edward J. Green (right) left the Bank in July to assume a teaching position at Pennsylvania State University in State College.

*Richard P. Anstee retired on December 31, 2004. Although Anstee was in charge of Technology, Finance, Support Services, and Corporate Communications for the majority of the year, his responsibilities transferred to other Management Committee members in October in anticipation of his retirement.

As of December 31, 2004

Michael H. Moskow
President and Chief Executive Officer

Gordon Werkema
First Vice President and Chief Operating Officer

Richard P. Anstee
Senior Vice President and General Counsel
Legal Relations, Office of the Directors and Enterprise Risk Management

William A. Baroski
Senior Vice President and General Counsel
Legal Relations, Office of the Directors and Enterprise Risk Management

Barbara D. Benson
Senior Vice President and General Counsel
Legal Relations, Office of the Directors and Enterprise Risk Management

Central Bank Activities

**Economic Research and Programs**

Charles L. Evans
Senior Vice President and Director of Research

Regional Economic Programs

William A. Testa
Senior Vice President and Director of Research

**Legal Relations & Financial Systems Risk Management**

Elizabeth A. Knope
Senior Vice President and General Counsel

Senior Vice President

Gordon Werkema
First Vice President and Chief Operating Officer

Michael H. Moskow
President and Chief Executive Officer

Institutions

Mark H. Kews
Vice President

Risk Specialists

Richard C. Cahill
Vice President

Services to Depository Institutions

Customer Relations and Support Office (CRSO)

William A. Baroski
Senior Vice President

Fedline for the Web

Ir R. Zist
Vice President and Program Director

Financial Planning and Controls, Budget, Forecasting, Revenue Management

Ellen J. Bronmagen
Vice President and Program Director

Microeconomic Policy Research

Daniel G. Sullivan
Senior Vice President and Economic Advisor

Support Functions

Technology, Protection, Administration, Statistics

Angela D. Robinson
Senior Vice President and EEO Officer
Technology, Protection, Administration, Statistics

Robert G. Wiley
Senior Vice President Financial Services Group

Payments Studies

Richard D. Porter
Vice President

Technology Group

David E. Ritter
Vice President

Administrative Services

Knut L. Zimmermann
Vice President

Statistics

Valerie J. Van Meter
Vice President

People Practices, Strategic Planning, Loans and Reserves, Finance and Leadership Development

Barbara D. Benson
Senior Vice President

Budget Reporting

Jeffrey S. Anderson
Vice President

Accounting, Loans and Reserves

Gerald J. Nick
Vice President

Office of the General Auditor

Margaret K. Koenigs
Vice President and General Auditor

Senior Vice President

Richard P. Anstee*

*Richard P. Anstee retired on December 31, 2004. Anstee oversaw Technology, Finance, Support Services, and Corporate Communications for the majority of the year. His responsibilities transferred to other Management Committee members in October in anticipation of his retirement.
Money Smart Advisory Councils

The Federal Reserve Bank of Chicago and its Detroit Branch coordinate Money Smart Advisory Councils in both Chicago and Detroit. They are made up of representatives of community, financial, government and educational organizations working together to promote financial literacy. Each council sponsors an annual Money Smart Week, which features a variety of activities for consumers that promote financial education. For a list of council members, please visit our Web site at chicagofed.org and go to “Advisory Councils” in the “About the Fed” section.

Advisory Councils

Federal Advisory Council

Seventh District

Representative

Dennis J. Kueser
Marshall & Isley Corporation

Milwaukee, Wisconsin

Seventh District

Advisory Council

Thomas Kendall Brown
Ford Motor Company

Dearborn, Michigan

Carl T. Camden
Kelly Services, Inc.

Troy, Michigan

Richard L. Clarke
Healthcare Financial Management Association

Westchester, Illinois

Emil B. Davis, Jr.
Alliant Energy

Madison, Wisconsin

Darcy L. Evan
Illinois Institute of Technology

Chicago, Illinois

Allen B. Hubbard
E&A Industries, Inc.

Indianapolis, Indiana

Katherine M. Hudson
Brady Corporation

Milwaukee, Wisconsin

Christopher P. LaMothe
Oxford Financial Group, Ltd.

Indianapolis, Indiana

Pamela Forbes Lieberman
TruServ Corporation

Chicago, Illinois

Bret R. Maxwell
MK Capital

Chicago, Illinois

Leslie Smith Miller
Iowa State Savings Bank

Knoxville, Iowa

David Newby
Wisconsin State AFL-CIO

Milwaukee, Wisconsin

Matthew Paul
McDonald’s Corporation

Oak Brook, Illinois

Robert G. Potter
United Food and Commercial Workers Local 951

Grand Rapids, Michigan

Quintin E. Primo III
Capri Capital

Chicago, Illinois

James R. Reilly
Chicago Convention and Tourism Bureau

Chicago, Illinois

Donald J. Schneider
Schneider National, Inc.

Green Bay, Wisconsin

Leland Strom
Strom Farm

Elgin, Illinois

Jim Theisen
Theisen Home Farm Auto

Dubuque, Iowa

Jace Wojcieszcz
Cambridge Capital Management Corp.

Indianapolis, Indiana

Advocacy Councils

Indianapolis, Indiana

Management Corp.

Jean Wojtowicz
Dubuque, Iowa

Jim Theisen
Elgin, Illinois

Strom Farm

Green Bay, Wisconsin

Chicago, Illinois

Tourism Bureau

Chicago Convention and Tourism Bureau

Chicago, Illinois

Schneider National, Inc.

Green Bay, Wisconsin

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Theisen Home Farm Auto

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Indianapolis, Indiana

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Elgin, Illinois

Theisen Home Farm Auto

Dubuque, Iowa

Cambridge Capital Management Corp.

Indianapolis, Indiana

FRBC 2004 ANNUAL REPORT

EXECUTIVE CHANGES

Directors

Members of the Federal Reserve Bank of Chicago’s boards of directors are selected to represent a cross section of the Seventh District economy, including consumers, industry, agriculture, the service sector, labor and commercial banks of various sizes.

The Chicago board consists of nine members. Member banks elect three bankers and three non-bankers. The Board of Governors appoints three additional non-bankers and designates the Reserve Bank chair and deputy chair from among its three appointees.

The Detroit Branch has a seven-member board of directors. The Board of Governors appoints three non-bankers, and the Chicago Reserve Bank board appoints four additional directors. The Branch board selects its own chair each year, with the approval of the Chicago board. All Reserve Bank and Branch directors serve three-year terms, with a two-term maximum.

Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 2004 were:

W. James Farrell re-appointed to a second three-year term as a director through 2006 and designated chairman

Miles D. White designated deputy chairman

John A. Canning, Jr. appointed to complete two years of an unexpired term through 2005

Mark T. Gaffrey elected a director through 2006

Michael L. Kubacki elected a director through 2006

Edsel B. Ford IV designated Branch chairman

Linda S. Likely appointed as Branch director to complete two years of an unexpired term through 2005

Ralph W. Babbs, Jr. appointed as Branch director through 2006

Roger A. Gregg appointed as Branch director through 2006

At year-end 2004 the following appointments and elections to terms beginning in 2005 were announced:

W. James Farrell re-appointed to a second one-year term as board chairman through 2006

Miles D. White re-appointed to a second three-year term as a director through 2007 and a second one-year term as deputy chairman

Mindy C. Meals elected a director through 2007

Jeff Flagg elected a director through 2007

Michael M. Mages, Jr. appointed a Branch director through 2007

Edsel B. Ford IV re-appointed to a second one-year term as Detroit Branch board chairman through 2005

Irvin D. Reid re-appointed to serve a second three-year term as a Branch director through 2007

Advisory Councils

The Federal Advisory Council, which meets quarterly to discuss business and financial conditions with the Board of Governors in Washington, D.C., is composed of one person from each of the 12 Federal Reserve Districts.

Each year the Chicago Reserve Bank’s board of directors selects a representative to this group. Dennis J. Kueser, president and chief executive officer, Marshall & Isley Corporation, was selected to be the 2005 representative.

The Seventh District Advisory Council members meet twice a year to provide their views on current business conditions to Chicago Fed President Michael Moskow and other senior officials of the Bank. Input from Council members on regional economic conditions helps contribute to the Federal Reserve System’s formulation of national monetary policy.

Executive Officers

A number of changes were made among the Bank’s executive officers during 2004.

The Bank’s board of directors acted on the following vice president and senior vice president promotions during 2004:

Catharine Lemieux to Senior Vice President of Supervision and Regulation

Ellen Bromagen to Vice President, Customer Relations and Support Office

Mark H. Kawa to Vice President, Supervision and Regulation

David A. Marshall to Vice President, Research

A new vice president appointed by the board in 2004 was:

Richard D. Porter to Vice President, Payments Research

The following executive officers retired during 2004:

Richard P. Anstee, Senior Vice President, Technology, Finance, Support Services and Corporate Communication retired after 31 years of service.

Charles W. Forbes, Senior Vice President, Financial Services Group, retired after 26 years of service.

James A. Bluemle, Vice President and Division Leader, Supervision and Regulation, retired after 31 years of service.

Thomas G. Cacioli, Vice President, Economic Research, retired after 34 years of service.

Richard L. Kuchhausen, Vice President, Customer Relations and Support Office, retired after 22 years of service.

Frank S. McKenna, Vice President, Financial Services Group, retired after 34 years of service.

FRBC 2004 ANNUAL REPORT

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OPERATIONS VOLUMES

<table>
<thead>
<tr>
<th>Check and Electronic Payments</th>
<th>Dollar Amount</th>
<th>Number of Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checks, NOWs and Share Drafts Processed</td>
<td>1.7 Trillion</td>
<td>2.0 Billion</td>
</tr>
<tr>
<td>Fine Sort and Packaged Checks Handled</td>
<td>10.3 Billion</td>
<td>15.1 Million</td>
</tr>
<tr>
<td>Images Captured</td>
<td>-</td>
<td>92.3 Million</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Operations</th>
<th>Dollar Amount</th>
<th>Number of Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>CurrencyReceived and Counted</td>
<td>53.2 Billion</td>
<td>3.7 Billion</td>
</tr>
<tr>
<td>Unfit Currency Destroyed</td>
<td>6.5 Billion</td>
<td>602.3 Million</td>
</tr>
<tr>
<td>Coin Bags Paid and Received</td>
<td>1.7 Billion</td>
<td>4.0 Million</td>
</tr>
<tr>
<td>Number of Notes Paid and Received</td>
<td>122.1 Billion</td>
<td>8.5 Billion</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loans to Depository Institutions</th>
<th>Dollar Amount</th>
<th>Number of Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Loans Made During Year</td>
<td>1.5 Billion</td>
<td>1.3 Thousand</td>
</tr>
</tbody>
</table>

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $2.0 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2004, the Bank did not engage PwC for any material advisory services.
Management Assertion  
March 2005  
To the Board of Directors of the Federal Reserve Bank of Chicago

The management of the Federal Reserve Bank of Chicago ("FRBC") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2004 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBC is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of internal controls are reported to management, and appropriate corrective measures are implemented.

Even an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the FRBC assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we believe that the FRBC maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of Chicago

Michael Moskow  
President

Gordon Werkema  
First Vice President

Barbara Benson  
Senior Vice President

Report of Independent Accountants  
To the Board of Directors of The Federal Reserve Bank of Chicago

We have examined management’s assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Chicago ("FRBC") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2004, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRBC’s management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management’s assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management’s assertion that FRBC maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2004 is fairly stated, in all material respects, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of management and the Board of Directors and Audit Committee of FRBC, and any organization with legally defined oversight responsibilities and is not intended to be and should not be used by anyone other than these specified parties.

March 16, 2005
## 2004 Financial Statements

### Statement of Condition, in Millions.

<table>
<thead>
<tr>
<th></th>
<th>As of December 31, 2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold certificates</td>
<td>$924</td>
<td>$982</td>
</tr>
<tr>
<td>Special drawing rights certificates</td>
<td>212</td>
<td>212</td>
</tr>
<tr>
<td>Coin</td>
<td>111</td>
<td>90</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>559</td>
<td>942</td>
</tr>
<tr>
<td>Loans to depository institutions</td>
<td>14</td>
<td>17</td>
</tr>
<tr>
<td>U.S. government securities, net</td>
<td>65,359</td>
<td>68,267</td>
</tr>
<tr>
<td>Investments denominated in foreign currencies</td>
<td>2,232</td>
<td>2,033</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>458</td>
<td>510</td>
</tr>
<tr>
<td>Interdistrict settlement account</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Bank premises and equipment, net</td>
<td>186</td>
<td>157</td>
</tr>
<tr>
<td>Other assets</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$70,320</td>
<td>$73,250</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Liabilities and Capital</strong></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve notes outstanding, net</td>
<td>$63,471</td>
<td>$58,694</td>
</tr>
<tr>
<td>Securities sold under agreements to repurchase</td>
<td>2,773</td>
<td>2,692</td>
</tr>
<tr>
<td>Deposits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository institutions</td>
<td>1,762</td>
<td>2,380</td>
</tr>
<tr>
<td>Other deposits</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Deferred credit items</td>
<td>421</td>
<td>781</td>
</tr>
<tr>
<td>Interest on Federal Reserve notes due U.S. Treasury</td>
<td>244</td>
<td>29</td>
</tr>
<tr>
<td>Interdistrict settlement account</td>
<td>–</td>
<td>6,831</td>
</tr>
<tr>
<td>Accrued benefit costs</td>
<td>83</td>
<td>93</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>36</td>
<td>28</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$68,794</td>
<td>$71,402</td>
</tr>
</tbody>
</table>

| **Capital**               | $763           | 924  |
| **Total Capital**         | 1,528          | 1,848 |

| **Total Liabilities and Capital** | $70,320 | $73,250 |

The accompanying notes are an integral part of these financial statements.
### Statements of Income, in Millions.

<table>
<thead>
<tr>
<th></th>
<th>For the years ended December 31, 2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on U.S. government securities</td>
<td>$2,041</td>
<td>$2,358</td>
</tr>
<tr>
<td>Interest on investments denominated in foreign currencies</td>
<td>28</td>
<td>27</td>
</tr>
<tr>
<td>Interest on loans to depository institutions</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>Total Interest Income</td>
<td>2,070</td>
<td>2,385</td>
</tr>
<tr>
<td><strong>Interest Expense</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense on securities sold under agreements to repurchase</td>
<td>28</td>
<td>23</td>
</tr>
<tr>
<td>Net Interest Income</td>
<td>2,042</td>
<td>2,362</td>
</tr>
<tr>
<td><strong>Other Operating Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from services</td>
<td>114</td>
<td>108</td>
</tr>
<tr>
<td>Reimbursable services to government agencies</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Foreign currency gains, net</td>
<td>129</td>
<td>276</td>
</tr>
<tr>
<td>Other income</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Total Other Operating Income</td>
<td>257</td>
<td>398</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and other benefits</td>
<td>143</td>
<td>169</td>
</tr>
<tr>
<td>Occupancy expense</td>
<td>21</td>
<td>22</td>
</tr>
<tr>
<td>Equipment expense</td>
<td>16</td>
<td>19</td>
</tr>
<tr>
<td>Assessments by Board of Governors</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Other expenses</td>
<td>83</td>
<td>65</td>
</tr>
<tr>
<td>Total Operating Expenses</td>
<td>339</td>
<td>350</td>
</tr>
<tr>
<td><strong>Net Income Prior to Distribution</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$1,960</td>
<td>$2,410</td>
</tr>
</tbody>
</table>

### Statements of Changes in Capital, in Millions.

<table>
<thead>
<tr>
<th></th>
<th>For the years ended December 31, 2004</th>
<th>December 31, 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital Paid-in</strong></td>
<td>$857</td>
<td>$857</td>
</tr>
<tr>
<td><strong>Surplus</strong></td>
<td></td>
<td>$857</td>
</tr>
<tr>
<td><strong>Total Capital</strong></td>
<td></td>
<td>$1,714</td>
</tr>
<tr>
<td>Balance at January 1, 2003 (12.2 million shares)</td>
<td>$857</td>
<td>$857</td>
</tr>
<tr>
<td>Transferred to surplus</td>
<td>-</td>
<td>67</td>
</tr>
<tr>
<td>Net change in capital stock issued (1.3 million shares)</td>
<td>67</td>
<td>-</td>
</tr>
<tr>
<td>Balance at December 31, 2003 (18.5 million shares)</td>
<td>$924</td>
<td>$924</td>
</tr>
<tr>
<td>Transferred (from) surplus</td>
<td>-</td>
<td>(161)</td>
</tr>
<tr>
<td>Net change in capital stock redeemed (3.2 million shares)</td>
<td>-</td>
<td>(161)</td>
</tr>
<tr>
<td>Balance at December 31, 2004 (15.3 million shares)</td>
<td>$763</td>
<td>$763</td>
</tr>
<tr>
<td>Total Distribution</td>
<td></td>
<td>$1,526</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.
1. Structure

The Federal Reserve Bank of Chicago ("Bank") is part of the Federal Reserve System ("system") created under the Federal Reserve Act of 1913 ("Federal Reserve Act") which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors"), the twelve Federal Reserve Banks ("Reserve Banks"), and the Federal Open Market Committee ("FOMC"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branch in Detroit, Michigan, serve the Seventh Federal Reserve District, which includes Iowa and portions of Michigan, Illinois, Wisconsin and Indiana.

Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Banks. Those Banks that are members of the System include all national banks and any state-chartered bank that applies for membership in the System.

Board of Directors

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks having ten or more directors. Banks which are state-chartered, representing the public. In any election of directors, each member bank has one vote, regardless of the number of shares of Reserve Bank stock it holds.

2. Operations and Services

The System performs a variety of services and operations. Functions include: formulating and conducting monetary and fiscal policy; providing a broad range of banking and financial services in the payments mechanism, including the clearing of checks, transfers of funds, and the delivery of currency; performing fiscal agency functions for the United States; providing short-term credit to depository institutions to facilitate the proper conduct of monetary policy; participating actively in the payments mechanism, including the large-dollar transfers of funds, automated clearinghouse ("ACH") operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the national bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

The FOMC establishes policy regarding open market operations; oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the Board to hold balances of, and to execute spot and forward foreign exchange transactions, and to exchange foreign currencies and securities contracts in, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained.

In addition, the FRBNY is authorized to maintain reciprocal currency arrangements ("FX swap") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

3. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of the System’s central bank have not been formulated by the Financial Accounting Standards Board. The Bank is required by GAAP to use specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the Financial Accounting Manual for General Reserve Banks ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and the accounting principles generally accepted in the United States of America ("GAAP"). The primary difference is the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included because the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. Other information regarding the Bank’s activities is provided in, or may be derived from, the Statements of GAAP. The Bank has calculated its SDR certificates in capital. A Statement of Cash Flows, therefore, would not provide any additional useful information.

There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided on behalf of the System by the Banks are not redistributed to the other Reserve Banks, include national business development and customer support.

The preparation of the financial statements in conformity with the Financial Accounting Standards Board requirements requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from these estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

A. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks. The gold held by the U.S. Treasury for the payment of gold certificates by the Reserve Banks is held by the U.S. Treasury. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury in the account for Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury. The U.S. Treasury must deliver the gold certificates to the Reserve Banks. The Reserve Banks are required to return the gold certificates to the U.S. Treasury. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury.

B. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member’s quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred among member countries for international payments. Under the law, providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat analogous to gold certificates, to Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2004 or 2003.

C. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reserve transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Therefore, at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury. The U.S. Treasury must deliver the gold certificates to the Reserve Banks. The Reserve Banks are required to return the gold certificates to the U.S. Treasury. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury.

The parties agree to exchange their respective currencies up to a pre-arranged maximum amount and for an agreed upon basis. Such arrangements are reviewed and approved annually by the FOMC.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the U.S. domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the FRBNY to take possession of collateral in excess of the market values of the securities loaned. The FRBNY makes the loans and the securities monitored are accounted for by the FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies at a specified rate, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg, a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed
upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FRBNY temporary access to foreign currencies it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawer. The FX swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an FX swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehoused funds is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases and sales of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of risk, because they represent contractual commitments involving future settlement and performance risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures while the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in unrealized gains or losses. The unrealized gains or losses on securities held to maturity, if any, are recorded directly in a reserve for unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of $61 million, representing one day’s interest on the SOMA portfolio, was accrued to reflect a change in interest accrual methods, of which $6.2 million was allocated to the Bank. The effect of the change was not material. Therefore, it was included in the 2003 interest income.

E. Bank Premises, Equipment and Software

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately support the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank’s capital and surplus changes, its holdings of the Reserve Bank stock must be adjusted. Member banks are those that have an account in the Federal Reserve system and are approved for membership in the System and all national banks. Carrying value of one-half of the subscription is paid in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Financial Accounting Standards Board (FASB) has deferred the implementation date for SFAS No 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity” for the Federal Reserve System. When applicable, the Bank will determine the impact and provide the appropriate disclosures.

F. Intrastate Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and accounts of foreign central banks as a payment in transit. The amount of transactions involving accounts residing in other Districts that occurred during the day’s operations. Such transactions may include funds settlement, check clearing and ACH operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the “Intrastate settlement account.”

G. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve banks in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank’s capital and surplus changes, its holdings of the Reserve Bank stock must be adjusted. Member banks are those that have an account in the Federal Reserve system and are approved for membership in the System and all national banks. Carrying value of one-half of the subscription is paid in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in and surplus, as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital.

Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or an increase in capital paid-in, payments to the U.S. Treasury are suspended and OMC income is credited to the surplus account. Federal Reserve note excess earnings are from or above the surplus account. Federal Reserve note excess earnings are from or above the surplus account.
liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY.


Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related proceeds, discounts, and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equates Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank’s allocated share of SOMA balances was approximately 9.008 percent and 10.105 percent at December 31, 2004 and 2003, respectively.

The Bank’s allocated share of U.S. Government securities, net held in the SOMA at December 31, was as follows (in millions):

<table>
<thead>
<tr>
<th>Security Type</th>
<th>Par Value</th>
<th>Income Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>$32,503</td>
<td>$9,951</td>
</tr>
<tr>
<td>Bills</td>
<td>$23,688</td>
<td>$24,740</td>
</tr>
<tr>
<td>Notes</td>
<td>$8,469</td>
<td>$9,951</td>
</tr>
</tbody>
</table>

The total of SOMA securities bought outright was $725,569 million and $675,569 million at December 31, 2004 and 2003, respectively.

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2004, was as follows (in millions):

<table>
<thead>
<tr>
<th>Maturity of Security Held</th>
<th>U.S. Gov't Securities (Par value)</th>
<th>Securities Sold Under Agreements to Repurchase (Contract amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 15 days</td>
<td>$8,775</td>
<td>$3,200</td>
</tr>
<tr>
<td>16 days to 30 days</td>
<td>15,555</td>
<td></td>
</tr>
<tr>
<td>31 days to 6 months</td>
<td>15,555</td>
<td></td>
</tr>
<tr>
<td>Over 1 year</td>
<td>14,500</td>
<td></td>
</tr>
<tr>
<td>Over 2 years</td>
<td>14,500</td>
<td></td>
</tr>
<tr>
<td>Over 5 years</td>
<td>14,500</td>
<td></td>
</tr>
<tr>
<td>Over 10 years</td>
<td>14,500</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$64,660</td>
<td>$13,200</td>
</tr>
</tbody>
</table>

5. Investments Denominated in Foreign Currencies

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

At December 31, 2004, the Bank allocates its share of investments denominated in foreign currencies, valued at current foreign currency market exchange rates at December 31, as follows (in millions):

<table>
<thead>
<tr>
<th>Maturity of Investments denominated in Foreign Currencies</th>
<th>European Union Euros</th>
<th>Japanese Yen</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 1 year</td>
<td>$3,337</td>
<td>$2,059</td>
<td>$5,396</td>
</tr>
<tr>
<td>Over 1 year</td>
<td>3,337</td>
<td>2,059</td>
<td>5,396</td>
</tr>
<tr>
<td>Over 2 years</td>
<td>3,337</td>
<td>2,059</td>
<td>5,396</td>
</tr>
<tr>
<td>Over 5 years</td>
<td>3,337</td>
<td>2,059</td>
<td>5,396</td>
</tr>
<tr>
<td>Over 10 years</td>
<td>3,337</td>
<td>2,059</td>
<td>5,396</td>
</tr>
<tr>
<td>Total</td>
<td>$13,200</td>
<td>$7,659</td>
<td>$20,859</td>
</tr>
</tbody>
</table>

The total system investments denominated in foreign currencies were $21,368 million and $19,868 million at December 31, 2004 and 2003, respectively.

6. Bank Premises, Equipment and Software

A summary of bank premises and equipment at December 31 is as follows (in millions):

<table>
<thead>
<tr>
<th>Bank premises and equipment</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$961</td>
<td>$1,062</td>
</tr>
<tr>
<td>Buildings</td>
<td>283</td>
<td>283</td>
</tr>
<tr>
<td>Construction</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>41</td>
<td>41</td>
</tr>
<tr>
<td>Subtotal</td>
<td>1,271</td>
<td>1,285</td>
</tr>
</tbody>
</table>

The Bank has capitalized software assets, net of amortization, of $14 million and $10 million at December 31, 2004 and 2003, respectively. Amortization expense was $1 million and $2 million for each of the years ended December 31, 2004 and 2003, respectively.

7. Commitments and Contingencies

At December 31, 2004, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately ten years. These leases provide for increased rentals based upon increases in real estate taxes or operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $9 million for each of the years ended December 31, 2004 and 2003. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2004, were (in thousands):

<table>
<thead>
<tr>
<th>Operating Leases</th>
<th>Capital Leases</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$3,566</td>
</tr>
<tr>
<td>2006</td>
<td>2,775</td>
</tr>
<tr>
<td>2007</td>
<td>2,106</td>
</tr>
<tr>
<td>2008</td>
<td>1,271</td>
</tr>
<tr>
<td>2009</td>
<td>756</td>
</tr>
<tr>
<td>2010</td>
<td>467</td>
</tr>
<tr>
<td>2011</td>
<td>439</td>
</tr>
<tr>
<td>2012</td>
<td>410</td>
</tr>
<tr>
<td>Total</td>
<td>$9,583</td>
</tr>
</tbody>
</table>

At December 31, 2004, the Bank, acting on its own behalf, entered into other commitments and long-term obligations extending through the year 2055 totaling $51.7 million. As of December 31, 2004, $11.8 million of these commitments was recognized. Purchases of $16.9 million and $4.1 million were made against these commitments in 2004 and 2003, respectively. These commitments represent services related to a new Detroit branch building that will be completed in 2005.
losses in excess of one percent of the
capital paid-in of the claiming Reserve Bank,
up to 50 percent of the total
capital paid-in of all Reserve Banks.
Losses are borne in the ratio that a
Reserve Banks capital paid-in bears to
the total capital paid-in of all Reserve Banks
at the beginning of the calendar year in which the loss
is shared. No claims were outstanding
under such agreement at December 31,
2004 or 2003.

The Bank is involved in certain legal
actions and claims arising in the ordinary
course of business. Although it is difficult
to predict the ultimate outcome of
these actions, in management’s opinion,
based on discussions with counsel, the
aforementioned litigation and claims
will be resolved without material adverse
effect on the Bank’s position or results of operations of the Bank.

8. Retirement and Thrift Plans

Retirement Plans

The Bank currently offers two defined
benefit retirement plans to its employees,
based on length of service and level of compensation.
Substantially all of the Bank’s employees participate in
the Retirement Plan for Employees of the Federal Reserve System (“System Plan”) and the Bank’s Equitable Retirement Plan (“BEP”). In addition, certain Bank officers participate in the Supplemental Employee Retirement Plan (“SERP”).

The System Plan is a multi-employer
plan with contributions fully funded by
participating employers. Participating
employers are the Federal Reserve
Banks, the Board of Governors of the
Federal Reserve System, and the Office of
Employee Benefits of the Federal Reserve
Employee Benefits System. No separate accounting is
maintained of assets contributed by the participating
employers. The FRBNY acts as a sponsor of
the Plan for the System and the
interests associated with the
Plan are not redistributed to the Bank. The Bank’s
projected benefit obligation and net
pension costs for the BEP and the SERP
at December 31, 2004 and 2003 and
for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution
Thrift Plan for Employees of the Federal Reserve System (“Thrift Plan”). The
Bank’s Thrift Plan contributions totaled $5.6 million and $5.9 million
for the years ended December 31, 2004 and 2003, respectively, and
are reported as a component of “Salaries and other benefits.”

9. Postretirement Benefits other than
Pensions and Postemployment
Benefits

Postretirement Benefits other than
Pensions

In addition to the Bank’s retirement
plans, employees who have met certain
age and length of service require-
ments are eligible for both medical
benefits and life insurance coverage
during retirement.

The Bank funds benefits payable
under the medical and life insurance
plans as due and, accordingly, has no
plan assets. Net postretirement benefit
cost is actuarially determined using
a January 1 measurement date.

Following is a reconciliation of
beginning and ending balances of the
benefit obligation (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>Fair value of plan assets at January 1</th>
<th>Actual return on plan assets</th>
<th>Contributions by the employer</th>
<th>Contributions by plan participants</th>
<th>Benefits paid</th>
<th>Fair value of plan assets at December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$ –</td>
<td>–</td>
<td>5.4</td>
<td>1.2</td>
<td>(6.1)</td>
<td>$ –</td>
</tr>
<tr>
<td>2003</td>
<td>$ –</td>
<td>–</td>
<td>5.2</td>
<td>0.9</td>
<td></td>
<td>$ –</td>
</tr>
</tbody>
</table>

At December 31, 2004 and 2003, the weighted-average discount rate
assumptions used in developing the
postretirement benefit obligation were 5.75 percent and 6.25 percent,
respectively.

Following is a reconciliation of
the beginning and ending balance of the plan
assets, the unfunded postretirement benefit obligation, and the accrued
postretirement benefit cost (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>Accumulated postretirement benefit obligation at January 1</th>
<th>Service cost-benefits earned during the period</th>
<th>Interest cost of accumulated postretirement benefit obligation</th>
<th>Actuarial loss</th>
<th>Curtailment gain</th>
<th>Contributions by plan participants</th>
<th>Benefits paid</th>
<th>Accumulated postretirement benefit obligation at December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$ 106.5</td>
<td>$ 1.3</td>
<td>5.9</td>
<td>5.0</td>
<td>(1.2)</td>
<td>1.2</td>
<td>(6.1)</td>
<td>$ 106.5</td>
</tr>
<tr>
<td>2003</td>
<td>$ 85.5</td>
<td>$ 1.9</td>
<td>5.5</td>
<td>5.0</td>
<td></td>
<td>1.9</td>
<td></td>
<td>$ 85.5</td>
</tr>
</tbody>
</table>

Accrued postretirement benefit costs are reported as a component of
“Accrued benefit costs.” For measurement purposes, the
assumed health care trend rate at December 31 is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Service costs</th>
<th>Interest cost of accumulated benefit obligation</th>
<th>Actuarial loss</th>
<th>Curtailment gain</th>
<th>Contributions by plan participants</th>
<th>Benefits paid</th>
<th>Amortization of resulting deficiency</th>
<th>Accumulated postretirement benefit obligation at December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$ 1.6</td>
<td>$ 12.4</td>
<td>4.4</td>
<td>(44.1)</td>
<td>(5.1)</td>
<td>(6.1)</td>
<td>0.5</td>
<td>$ 106.5</td>
</tr>
<tr>
<td>2003</td>
<td>$ 6.0</td>
<td>$ 9.5</td>
<td>5.0</td>
<td>(5.5)</td>
<td></td>
<td></td>
<td></td>
<td>$ 85.5</td>
</tr>
</tbody>
</table>

At December 31, 2004 and 2003, the weighted-average discount rate
assumptions used to determine net
periodic postretirement benefit costs were 6.25 percent and 6.75 percent,
respectively.

Net periodic postretirement benefit costs are reported as a component of
“Salaries and other benefits.”

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2004 (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>One Percentage Point Increase</th>
<th>One Percentage Point Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$ 1.3</td>
<td>$ (0.9)</td>
</tr>
</tbody>
</table>

A plan amendment that modified the credited service period eligibility
requirements created curtailment gains. The recognition of special
termination losses is primarily the result of enhanced retirement benefits
provided to employees during the
restructuring described in footnote 10. Because the special termination loss is less than $50,000, the amount is not displayed in the tables above.

The curtailment gain associated with restructuring programs announced in
2004 that are described in footnote
10 will be offset by the unrecognized actuarial losses and prior service
gains. As a result, an unrecognized net curtailment gain will be recorded in
2005 when the affected employees terminate employment.

The Medicare Prescription Drug
Improvement and Modernization Act
of 2003 (the “Act”) was enacted in
December 2003. The Act established a prescription drug benefit under
Medicare (“Medicare Part D”) and a federal subsidy to sponsors of retiree
health care benefit plans that provide benefits that are at least actuarially
equivalent to Medicare Part D. Following the guidance of the Financial
Accounting Standards Board, the Bank elected to defer recognition of the
financial effects of the Act until further
guidance was issued in May 2004.

Benefits provided to certain
participants are at least actuarially equivalent to
Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the
accumulated postretirement benefit obligation and net periodic
postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>Without Subsidy</th>
<th>With Subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$ 6.2</td>
<td>$ 6.2</td>
</tr>
<tr>
<td>2006</td>
<td>$ 6.0</td>
<td>$ 6.0</td>
</tr>
<tr>
<td>2007</td>
<td>$ 6.0</td>
<td>$ 6.0</td>
</tr>
<tr>
<td>2008</td>
<td>$ 6.0</td>
<td>$ 6.0</td>
</tr>
<tr>
<td>2009</td>
<td>$ 6.2</td>
<td>$ 6.2</td>
</tr>
<tr>
<td>2010-2014</td>
<td>$ 33.3</td>
<td>$ 31.8</td>
</tr>
<tr>
<td>Total</td>
<td>$ 61.6</td>
<td>$ 62.2</td>
</tr>
</tbody>
</table>

Postemployment Benefits

The Bank offers benefits to former or
inactive employees. Postemployment benefit costs are actuarially
determined using a December 31, 2004 measurement date and include
the cost of medical and dental insurance, survivor income, and disability benefits.
For 2009, the Bank changed its practices for projecting postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, were projected using the same discount rate and health care
trend rates as were used for projecting postretirement costs. The accrued
postemployment benefit costs recognized by the Bank at December 31, 2004 and 2003, were $12 million and $13 million, respectively. This cost is included as a component of “Accrued benefit costs.” Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were $1 million and $2 million, respectively.
10. Business Restructuring Charges

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004, additional consolidation and restructuring initiatives were announced in the check operation. These actions resulted in the following business restructuring charges and asset impairment costs:

Major categories of expense (in millions):

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee separation</td>
<td>$8.0</td>
<td>$6.7</td>
<td>$1.3</td>
<td>$4.2</td>
</tr>
<tr>
<td>Contract termination</td>
<td>0.6</td>
<td>0.6</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Total</td>
<td>$8.6</td>
<td>$7.3</td>
<td>$1.3</td>
<td>$4.2</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 334, including 262 staff reductions related to restructuring announced in 2003. These costs are reported as a component of “Salaries and other benefits.” Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of “Other expenses.”

Costs associated with the write-downs of certain Bank assets, including software, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2005.

The Bank anticipates substantially completing its announced plans by March 2005.

10. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004, additional consolidation and restructuring initiatives were announced in the check operation. These actions resulted in the following business restructuring charges and asset impairment costs:

Major categories of expense (in millions):

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee separation</td>
<td>$8.0</td>
<td>$6.7</td>
<td>$1.3</td>
<td>$4.2</td>
</tr>
<tr>
<td>Contract termination</td>
<td>0.6</td>
<td>0.6</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Total</td>
<td>$8.6</td>
<td>$7.3</td>
<td>$1.3</td>
<td>$4.2</td>
</tr>
</tbody>
</table>

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The Federal Reserve Bank of Chicago is one of 12 regional Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as the nation’s central bank. The role of the Federal Reserve System, since its establishment by an act of Congress passed in 1913, has been to foster a strong economy, supported by a stable financial system.

To this end, the Federal Reserve Bank of Chicago participates in the formulation and implementation of national monetary policy, supervises and regulates state-member banks, bank holding companies and foreign bank branches; and provides financial services to depository institutions and the U.S. government. Through its head office in Chicago, branch in Detroit, regional office in Des Moines, and facility in Bedford Park, Ill., the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes major portions of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

Our mission

Our vision

- Further the public interest by fostering a sound economy and stable financial system
- Provide products and services of unmatched value to those we serve
- Set the standard for excellence in the Federal Reserve System
- Work together, value diversity, communicate openly, be creative and fair
- Live by our core values of integrity, respect, responsibility and excellence

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